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ABSTRACT

Most National Education Association (NEA) members are covered by a type of retirement plan called a defined benefit pension plan, which provides a specific benefit periodically throughout an employee's retirement. This report provides an overview of the federal tax rules relating to the different types of retirement plans, savings plans, health plans, and dependent care plans that are available to members of the National Education Association. It describes how defined benefit pension plans work, what special tax advantages are available, and what restrictions apply. This report also describes in the same manner several other types of retirement and savings plans that may function as effective supplements to defined benefit pension plans, or as an employer's only purchased plan. The appendix to this report provides basic information with respect to state income tax rules applicable to employee benefit plans. (LAP)

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Federal rules as of August 15, 1990

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Introduction

This report provides an overview of the federal tax rules relating to the different types of retirement plans, savings plans, health plans, and dependent care plans that are available to members of the National Education Association. The report is intended to serve as an important first step in the consideration of the different types of employee benefit plans.

Most NEA members are covered by a type of retirement plan called a defined benefit pension plan, which provides a specific periodic benefit throughout an employee's retirement. This report describes how defined benefit pension plans work, what restrictions apply, and what special tax advantages are available. The report also describes in the same manner several other types of retirement and savings plans that can function effectively either as a supplement to a defined benefit pension plan or as an employer's only plan.

Careful attention to the rules set forth in this report can mean very significant savings for NEA members. On July 12, 1990, the *Baltimore Sun* criticized Baltimore in the following terms:

> City officials have failed to take advantage of an Internal Revenue Service provision that would allow the city to shield its teachers from federal taxes on employee contributions to pension plans. The result would be an extra $365 to $824 each year in take-home pay for city teachers.

The provision at issue is contained in Section 414(h) of the Internal Revenue Code and is commonly referred to as the "pick-up" rule.

The pick-up rule is just one example of the fact that the more NEA bargaining representatives and NEA members understand about the rules, the better their benefits will be and the greater their tax savings will be. In addition, an understanding of these rules can help representatives and members identify potentially harmful proposals to modify the law at either the federal or state level. Informed members acting together can make a difference in how new rules are shaped.

Employee benefit plans maintained on behalf of NEA members are exempt from many rules applicable to employee benefit plans maintained by private employers. In addition, plans that are the product of collective bargaining, as is the case with most plans for NEA members, receive further special treatment. This report incorporates the applicable exemptions and special rules.

This report is based on the law in effect on August 15, 1990. The law with respect to employee benefit plans has been modified numerous times in the past, and it is anticipated that modifications will continue. Accordingly, it is imperative that NEA bargaining representatives seek further guidance before making any final decisions.

The Appendix to this report provides basic information with respect to state income tax rules applicable to employee benefit plans.

Retirement and Savings Plans

Background

Deferred compensation plans in general

The retirement and savings plans discussed below are all forms of "deferred compensation plans." Under a deferred compensation plan, the employees receive in subsequent years certain compensation earned currently.

Under certain types of plans, the decision whether to receive compensation currently or in a subsequent year is made by each employee. These types of plans are referred to in this report as "elective plans." Under other types of plans, the amount of deferred compensation provided with respect to any employee is determined under a formula that no individual employee can alter. These types of plans are referred to as "nonelective plans." There are also hybrid plans that combine both elective and nonelective features.

Retirement plans vs. savings plans

Deferred compensation plans can be used for one of two purposes. First, a deferred compensation plan can be used to provide an individual with income replacement after she or he has retired. Second, a deferred compensation plan can be used to provide an individual with a means to save money for preretirement purposes (such as buying a home).

All of the deferred compensation plans described below can be used to provide retirement income. Certain plans are more effective in this regard than others.

Some, but not all, of the plans described below can be used as preretirement savings plans. However, certain aspects of the law (see "Special Rules" below) undermine the effectiveness of these plans as preretirement savings plans.

Qualified plans vs. nonqualified plans

Deferred compensation plans are often referred to as "qualified" or "nonqualified."[1] In general, only defined benefit pension plans and defined contribution plans, both of which are described below, are qualified plans. A qualified plan is required to satisfy certain technical requirements, which vary depending on the type of qualified plan. Satisfaction of these requirements entitles the plan and the employees benefiting under the plan to certain favorable tax treatment, which is also described below. In addition, under a qualified plan an employee's deferred compensation is not held by the employer but is made more secure by placement in, for example, a trust or annuity contract.

Nonqualified plans are not required to satisfy the technical requirements applicable to qualified plans. Accordingly, they are not entitled to the same favorable tax treatment. However, if a nonqualified plan meets certain less restrictive requirements, the plan and the employees enjoy certain tax advantages. These tax advantages do not apply, however, unless the employer holds the deferred compensation, subject to the employer's creditors.

In addition, there are two types of deferred compensation plans that are commonly viewed as

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[1] Although the use of the terms "qualified" and "nonqualified" is widespread, they are not technical terms. Accordingly, they are used by different people to mean different things. This report describes the most common usage of the terms, but it is recommended that more specific terminology be used in contract negotiations to avoid misunderstandings.

neither qualified nor nonqualified: tax-sheltered annuity plans (Section 403(b) plans) and simplified employee pensions (SEPs). Because these plans generally resemble qualified plans with respect to the aspects discussed above, they are referred to in this report as qualified plans.

Basic Features of Deferred Compensation Plans

This report describes the basic features of the five main types of deferred compensation plans: (1) defined benefit pension plans, (2) defined contribution plans, (3) Section 403(b) plans, (4) SEPs, and (5) nonqualified deferred compensation plans (Section 457 plans). The report also summarizes the special rules applicable to deferred compensation plans, including the requirements applicable to each type of plan and the tax treatment of distributions from each.

Defined benefit pension plans — Code Section 401(a)

A defined benefit pension plan is a qualified plan under Section 401(a) of the Internal Revenue Code. Under a defined benefit pension plan, employees earn, during their career with the employer, the right to a specified pension payment each year during retirement.

For example, a defined benefit pension plan might provide that for each year that employees work for an employer, they earn 1 percent of their "final average compensation." Final average compensation could be defined as the average compensation earned during the last five years of employment. Thus, assume that an employee starts work for an employer at age 35 and retires at age 65. Assume further that such employee's average compensation during the last five years of employment was $35,000. Under the plan described above, this employee would be entitled to an annual pension payment of 30 × .01 x $35,000 = $10,500. (The "30" represents years of service, the ".01" is the 1 percent per year of service, and the $35,000 is the final average compensation.) Thus, starting at age 65, this employee would receive $10,500 every year until her/his death; typically the payments would be made on a monthly basis.

Source of payments

The payments made to employees under a defined benefit pension plan are typically made from a trust. The employer makes contributions to this trust as the employees are working so that when the employees retire there is enough money in the trust to make the pension payments.

In general, until all benefits earned by employees have been paid to the employees (or their beneficiaries), the trust assets may only be used to make such payments or to pay administrative expenses incurred by the plan. (The extent to which the plan, rather than the employer, pays administrative expenses should be bargained over.) Under certain circumstances, assets in excess of the amount needed to provide employees with their benefits (or to pay administrative expenses, if applicable) may revert to the employer. See "Special Rules — Miscellaneous" below.

Elective plans vs. nonelective plans

A defined benefit pension plan can be structured either as an elective plan or a nonelective plan. The plan described above is a nonelective plan. The benefit provided to any employee depends solely on the application of the pension formula; employees may not make any elections that affect the application of the formula.

The plan could be made into an elective plan by requiring that employees, as a condition of being in the plan in any year, contribute, for example, 1 percent of their compensation to the trust. If each employee is permitted to decide whether or not to make a contribution, then the plan is elective and any contribution made by an employee is an "after-tax" contribution.

For example, assume that an employee is entitled to a salary of $30,000. In order to participate in the elective plan described above, the employee must elect to contribute 1 percent of $30,000, i.e., $300. That $300 would be an after-tax contribution. In other words, although the $300 would be deducted from her/his paychecks, taxes would still be based on the full $30,000. It is as though the $30,000 had been received and then a nondeductible contribution of $300 had been made to the trust.

A plan may be nonelective even though employee contributions are required as a condition of participation in the plan. For example, the employee contributions could be required as a condition of employment. Generally, such employee contributions would also be after-tax contributions. However, there is a special rule that applies with respect to employee contributions if, in general, employees do not have the right to receive the amount of the contribution directly, instead of having the amount contributed to the plan. Under this special rule, which is contained in Section 414(h) of the Internal Revenue Code, the employer may choose

to "pick up" the employee contribution. The result of the employer picking up the employee contribution is that, for federal income tax purposes, the contributions cease to be after-tax employee contributions and become "pretax" *employer* contributions.[2] (Because pick-up contributions are treated as employer contributions, they are not subject to the limits on pretax employee contributions.)

For example, assume that the same $30,000-a-year employee described above is covered under a "condition of employment" plan. Assume further that the employer picks up the $300 contribution. Under a common pick-up arrangement, everything is the same as described in the prior example except that the employee is only taxed on $29,700. In other words, the employer does not make any extra contributions and the employee has the same $300 deducted, but is taxed as if she/he did not receive that $300.

Aside from elective and nonelective plans, there can also be hybrid plans under which a certain benefit is provided to all eligible employees on a nonelective basis but higher benefits are only available if an employee makes an elective contribution to the trust.

Forms of payment

A common form of payment under a defined benefit pension plan is a life annuity, i.e., a set amount per year starting at retirement and continuing until the employee's death.

One common variation would be a joint and survivor annuity based on the lives of the employee and her/his beneficiary. Such an annuity might operate in the same manner as a life annuity during the employee's lifetime, then provide a second life annuity to the employee's beneficiary. The second life annuity might be equal in annual payments to the employee's life annuity or it may be a percentage of the employee's life annuity. For example, an employee might receive $10,000 a year during retirement and her/his beneficiary might receive half that amount ($5,000) a year during the period between the employee's death and the beneficiary's death. Benefits paid in the form of a joint and survivor annuity generally are less during the employee's lifetime than those paid to an employee who receives an annuity only for her/his own life.

Another common form of payment is a life annuity with a term certain. Under such an annuity, payments for a specified number of years (the "term certain") are made even if the employee and beneficiary die before that point (with the extra payments made to contingent beneficiaries).

The amount paid annually under the annuities described above may be subject to cost-of-living adjustments (COLAs). Such COLAs may be automatic, ad hoc, or contingent on specified events (such as trust earnings).

A defined benefit pension plan may also allow an employee to choose to receive, instead of an annuity, a single lump-sum payment equal to the present value of the available annuity payments. In fact, a plan might require an employee to receive a lump-sum payment at least under certain circumstances, e.g., if the employee terminates employment prior to retirement age with a small vested benefit under the plan.

A defined benefit pension plan may also provide a combination of an annuity and a lump-sum payment. For example, a plan may permit employees to choose to receive the benefit attributable to their own employee contributions in a lump sum and to receive their employer-derived benefit in an annuity form.

The forms of distribution described above are among the more common ones.

General tax treatment

Employees are not taxed when employer contributions are made to a trust under a defined benefit pension plan. A distribution from the trust is taxable income to the recipient, however, except to the extent that the distribution is "rolled over" or is considered to be a return of the employee's after-tax contributions.

Subsequent sections ("Special Rules") of this report provide further guidance with respect to (1) deferring taxation of a distribution by rolling over the distribution into certain other deferred compensation plans or into an individual retirement arrangement (IRA); (2) determining the portion of any distribution that consists of an employee's after-tax contributions; (3) penalty taxes that apply to certain distributions; and (4) special means of reducing the rate at which a distribution is taxed.

In general, neither contributions (other than after-tax contributions) to the trust nor distributions from it are subject to the Social Security tax (even if such tax generally applies to an NEA member).[3]

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[2] In certain circumstances, an alternative means of having nonelective employee contributions made on a pretax basis is simply to designate them as employer contributions. See also "Special Rules - Miscellaneous" below. This concept also applies to other types of qualified plans.

[3] References in this report to the Social Security tax include the hospital insurance tax as well as the old age, survivors, and disability insurance tax.

However, a pick-up contribution is subject to the Social Security tax (if such tax generally applies) to the extent that the contribution is made pursuant to a salary reduction agreement. For this purpose, a salary reduction agreement need not be in writing.

Trust earnings are generally exempt from taxation.

Defined contribution plans — Code Section 401(a)

Like a defined benefit pension plan, a defined contribution plan is a qualified plan under Section 401(a) of the Internal Revenue Code. However, under a defined contribution plan, each participating employee has an account in the plan. Contributions are made to that account by the employer and/or by the employee. The earnings attributable to those contributions are also credited to the employee's account. Thus, defined contribution plans function like bank accounts.

The primary difference between a defined contribution plan and a defined benefit pension plan is that in the former the employer only commits to a certain level of contributions. Accordingly, unlike a defined benefit pension plan, the amount of assets available to the employee for retirement (or preretirement purposes) is, in all cases, solely a function of the contributions to the trust and the earnings generated by those contributions.

There are two types of defined contribution plans that are relevant for NEA members: money purchase pension plans and profit-sharing plans. Until the Tax Reform Act of 1986, there was some question as to whether a public employer could maintain a profit-sharing plan since it did not have profits in the traditional sense. The Tax Reform Act of 1986 provided, however, that an employer could maintain a profit-sharing plan even if it did not have profits. In effect, although the name "profit-sharing plan" remained, the existence of profits became irrelevant. Accordingly, it became clear that public employers could maintain a profit-sharing plan. Although private employers typically retain discretion on a year-to-year basis as to whether to make a contribution to a profit-sharing plan, that is not a necessary component of a profit-sharing plan. An employer can be required under a profit-sharing plan (or a collective bargaining agreement) to make a specified level of contributions to a profit-sharing plan.

Accordingly, there are few differences for NEA members between money purchase pension plans and profit-sharing plans. In fact, the differences that do exist favor the adoption of a profit-sharing plan. Except as specifically noted, the discussions below of defined contribution plans apply both to money purchase pension plans and to profit-sharing plans.

Although the term "profit-sharing plan" is the term used in the Internal Revenue Code, an employer that adopts a profit-sharing plan has discretion with respect to whether to include the term in the actual name of the plan. For example, a public employer that finds the term inappropriate might refer to a profit-sharing plan as a retirement plan, a supplemental retirement plan, or a savings plan.

Source of payments

Same as defined benefit pension plans described above, except that in almost all cases, all employer and employee contributions and the income earned by such contributions are allocated to employees' accounts and are thus payable to the employees or their beneficiaries (net of the administrative expenses charged to the plan). However, employees are not entitled to more than that amount unless the employer has failed to make required contributions.

Elective plans vs. nonelective plans

A defined contribution plan may be structured as an elective plan, a nonelective plan, or a hybrid. An example of a nonelective plan would be a plan under which the employer contributes on behalf of each eligible employee an amount equal to 5 percent of such employee's compensation.

The following is an example of an elective plan. Under the plan, employees may elect to contribute to the trust any amount up to 3 percent of their compensation. In addition, for every dollar contributed by the employee, the employer will also contribute a dollar (or a different figure, such as fifty cents or two dollars). The employee may also have the option of making additional contributions to the plan that are not "matched" by the employer. Alternatively, a plan may be structured so that an employee may elect whether to make contributions but none of such contributions is matched by the employer. In general, employee contributions to a defined contribution plan must be after-tax contributions. In order for an employee contribution to be made on a pretax basis, it must either (1) be made under a pick-up arrangement, which is nonelective as described above (in which case it is treated as an employer contribution) or (2) be made under a special type of elective plan commonly referred to as a "401(k) plan."

The general rule, however, is that a state or local government may not maintain a 401(k) plan. Under an exception to this rule, a state or local government that had adopted a 401(k) plan before May 6, 1986, may maintain a 401(k) plan on behalf of any of its employees, including employees not covered before May 6, 1986.

Forms of payment

Payments made from a defined contribution plan may be made in the same forms described above with respect to defined benefit pension plans. However, lump-sum payments are more common with respect to defined contribution plans. In addition, installment payments made over a specified number of years are not uncommon in defined contribution plans. If a defined contribution plan does make a distribution in an annuity form, it is done by using the employee's account to purchase an annuity contract from an insurance company.

General tax treatment

Same as defined benefit pension plans described above, except that pretax employee contributions under a 401(k) plan are subject to the Social Security tax (if otherwise applicable).

Section 403(b) plans

All Section 403(b) plans are structured either as defined benefit pension plans or defined contribution plans. The reason that Section 403(b) plans merit separate discussion in this report is that Section 403(b) plans are subject to their own special rules. Section 403(b) plans may only be maintained by an employer that is either a public educational organization or a certain type of private nonprofit organization.

Because Section 403(b) plans are much more frequently structured as defined contribution plans, this report discusses them in that context.

Source of payments

In general, contributions by an employer or employee under a Section 403(b) plan must be either (1) used to purchase an annuity contract for the employee or (2) paid into a custodial account[4] and invested in regulated investment company stock (i.e., mutual funds) on behalf of the employee. (Thus, there is no trust.) Both arrangements function like a defined contribution plan: the employee is entitled to the contributions and to the earnings attributable to those contributions that are generated by the annuity contract or custodial account.

Elective plans vs. nonelective plans

The discussion above of elective and nonelective defined contribution plans applies to Section 403(b) plans with two important exceptions. First, employee contributions under a Section 403(b) plan may be made on a pretax basis regardless of whether they are elective or nonelective. In fact, elective pretax employee contributions are the most common form of contribution under a Section 403(b) plan. Second, the pick-up rules do not apply.

Forms of payments

Same as defined contribution plans described above.

General tax treatment

Same as defined benefit pension plans described above, except that (1) the special means of reducing the tax rate applicable to a distribution do not apply, (2) pretax employee contributions are subject to the Social Security tax (if otherwise applicable), and (3) as noted, the pick-up rules do not apply.

Simplified Employee Pensions (SEPs) — Code Section 408(k)

A SEP is, in effect, a special type of defined contribution plan that is established under Section 408(k) of the Internal Revenue Code. Under a SEP, the employer makes contributions to IRAs established on behalf of all the eligible employees.

Source of payments

Under a SEP, all payments to an employee (or her/his beneficiaries) are made from the employee's IRA.

Elective plans vs. nonelective plans

Only nonelective employer contributions may be made to a SEP maintained by a state or local government.

[4] A custodial account is generally an account established with a bank or similar institution in which Section 403(b) funds may be held.

Forms of payment

Same as defined contribution plans described above.

General tax treatment

Same as defined benefit pension plans described above, except that (1) the special means of reducing the tax rate applicable to a distribution do not apply and (2) the rules relating to employee contributions do not apply because there are no employee contributions.

Section 457 plans

In general, deferred compensation plans that do not "qualify" as defined benefit pension plans, defined contribution plans, Section 403(b) plans, or SEPs are nonqualified deferred compensation plans. (The basic standards that deferred compensation plans must satisfy to "qualify" are discussed below under "Special Rules.") Nonqualified deferred compensation plans fall into two categories: "Section 457(a) plans" and "Section 457(f) plans." The difference between the two categories is that Section 457(a) plans meet certain requirements and thereby qualify for more favorable tax treatment.

Section 457(f) plans essentially include any deferred compensation plan maintained by a state or local government that does not qualify as a Section 457(a) plan or as one of the other categories of plans described above. The tax treatment of Section 457(f) plans is generally unfavorable. The primary unfavorable aspect is that employees are generally taxable on the deferred compensation provided under a Section 457(f) plan when their rights to such compensation become substantially vested, even though they may not at that time have received the deferred compensation in current cash. Because of the unfavorable treatment of Section 457(f) plans, this report does not discuss these plans further and references to deferred compensation plans are intended to be references to plans other than Section 457(f) plans. Although Section 457(a) plans can be structured either like defined benefit pension plans or defined contribution plans, the latter are much more common and, accordingly, this report discusses Section 457(a) plans in that context.

Source of payments

Under a Section 457(a) plan, the employer simply promises to make certain payments to employees at a subsequent time. There may or may not be a trust, annuity contract, or custodial account to which contributions are made. Even if a trust, etc., is established, the assets placed in the trust may not be restricted to make payments under the Section 457(a) plan but rather must be available to the employer's general creditors.

The absence of a trust does not mean that an employee is not credited with contributions and earnings on those contributions. Contributions on behalf of an employee, whether made by the employer or the employee, are credited to the employee and held by the employer as part of its general assets. The employee is also credited with earnings based either on a stated rate of return established by the employer (such as 6 percent) or based on the actual rate of return earned by the employer with respect to investments made with the employee's deferred compensation.

Elective plans vs. nonelective plans

A Section 457(a) plan may be elective, nonelective, or a hybrid, as in the case of a defined contribution plan. However, most typically it is a purely elective plan, i.e., only elective employee contributions are made. Although it is unclear whether after-tax employee contributions to a Section 457(a) plan are permitted, the issue is moot because all employee contributions to such a plan can and should be made on a pretax basis.

Forms of payment

Same as defined contribution plans described above.

General tax treatment

Same as defined benefit pension plans described above, except that (1) all distributions from a Section 457(a) plan are taxable (because there are no after-tax employee contributions or rollovers); (2) under certain circumstances, an employee who has a right to receive a distribution from a Section 457(a) plan upon demand is taxable on the amount available, even if not distributed; (3) Section 457(a) plans are not subject to the penalty taxes, special lower tax rates, or pick-up rules applicable to defined benefit pension plans; and (4) a contribution to a Section 457(a) plan is subject to the Social Security tax (if otherwise applicable) when the contribution is vested.

Special Rules Applicable to Deferred Compensation Plans

The tax treatment described above for qualified deferred compensation plans is very favorable. For example, under general tax principles, individuals are taxable on amounts paid into a trust on their behalf by their employer if and when such amounts become substantially vested, even if they have not at that time received the deferred compensation in current cash compensation. Also under general tax principles, the income earned by such a trust is subject to income tax. The more favorable tax treatment of qualified plans is, however, conditioned on the plans' meeting the applicable standards for qualification.[5] These rules are summarized below.

With respect to nonqualified deferred compensation plans, a Section 457(a) plan is treated favorably as compared to a Section 457(f) plan, as discussed above. Such treatment is conditioned on the Section 457(a) plan meeting certain requirements, which are also discussed below.

In addition, this section of the report describes certain special rules with respect to the tax treatment of distributions from deferred compensation plans.

Availability of plan assets for distribution to employees

Prohibitions on availability

In order to qualify for favorable tax treatment, a deferred compensation plan must restrict an employee's ability to receive assets from the plan prior to the occurrence of certain events.

A plan may be more restrictive than is required by law. For example, even if the law would permit a certain type of plan to make distributions to an employee prior to termination of employment, the plan may by its terms prohibit such distributions.

Defined benefit pension plans. A defined benefit pension plan may not make a distribution to an employee of benefits funded by the employer until the employee has terminated employment, become disabled, attained normal retirement age under the plan, or died or until the plan has terminated.

After-tax employee contributions and the income attributable to such contributions are, however, subject to different rules. If no employer-funded benefit is conditioned on an after-tax employee contribution, a defined benefit pension plan may provide that such contribution and the income attributable to such contribution may be withdrawn by the employee at any time. If, however, an employer-funded benefit has been conditioned on the after-tax employee contribution, such contribution and the income thereon appear to be subject to the same restrictions applicable to employer-funded benefits, with very limited exceptions.

Defined contribution plans. Distributions from a money purchase pension plan are subject to the same restrictions applicable to a defined benefit pension plan.

The rules with respect to distributions from a profit-sharing plan are much more liberal than those applicable to defined benefit pension plans. A profit-sharing plan generally may distribute to an employee any employer contributions and the income attributable to such contributions if (1) the assets to be distributed have been in the trust for at least two years; (2) the employee has attained an age specified in the plan (which need not be normal retirement age); (3) an event has occurred with respect to the employee (such as layoff, hardship, illness, disability, retirement, death, or severance of employment); (4) the plan terminates; or (5) the employee has participated in the plan for at least five years.

A 401(k) plan, which is generally a type of profit-sharing plan, is, however, subject to restrictions on distributions of pretax employee contributions (and certain employer contributions) and the income thereon that are more restrictive than those applicable to other profit-sharing plans (but not as restrictive as those applicable to defined benefit pension plans).

After-tax employee contributions to profit-sharing plans are subject to the most liberal distribution rules. If no employer contribution is conditioned on an after-tax employee contribution, a profit-sharing plan may provide that the employee contribution and the income attributable thereto may be withdrawn by the employee at any time. If an employer contribution has been conditioned on the employee contribution, the plan may allow employees to have this same freedom of withdrawal, except that the plan has to provide a mechanism for, in effect, limiting the exercise of these withdrawal rights. Such a limitation might require, for example, that the amount withdrawn have been in the plan for a certain minimum period (such as two years). If employees wish to exercise their withdrawal rights prior to the expiration of such period, an alternative limitation might be the suspension of the employee's

[5] The IRS has stated, however, that pending further review, it will not challenge the tax-exempt status of trusts maintained in connection with the retirement plan of a state or local government.

right to make or receive contributions for six months following exercise of the withdrawal rights.

Section 403(b) plans. Under a Section 403(b) plan, amounts that are used to purchase annuity contracts generally may be distributed at any time. This rule, however, does not apply to elective pretax employee contributions and the income attributable to such contributions. Such pretax employee contributions may not be distributed until the employee attains age 59, separates from service, dies, becomes disabled, or incurs a hardship. The same restrictions apply to the income earned on elective pretax employee contributions except that the hardship rule does not apply.

Under a "grandfather rule," the restrictions on distribution of elective pretax employee contributions (and the income thereon) do not apply to amounts that were in the plan as of the end of the last plan year beginning before 1989. (The restrictions do apply, however, to the earnings on the grandfathered amounts.)

All amounts in a Section 403(b) plan that are held in a custodial account are subject to the same distribution restrictions applicable to elective pretax employee contributions used to purchase an annuity contract, except that the grandfather rule does not apply.

SEPs. Distributions from a SEP may be made at any time.

Section 457 plans. Under a Section 457(a) plan, distributions with respect to an employee may not be made until the employee separates from service or has an unforeseeable emergency (which is a narrower category than "hardship").

Ten percent early distribution penalty tax. Even if a deferred compensation plan may make a distribution under the rules described above without jeopardizing its favorable tax treatment, a 10 percent penalty tax will apply to the recipient of a taxable distribution unless the distribution is—

(i) made on or after the date the employee attains 59

(ii) made on or after the employee's death

(iii) attributable to the employee being disabled

(iv) made in the form of a life annuity, a joint and survivor annuity, or a similar form, provided that the payments begin after the employee separates from service

(v) made after the employee separates from service, provided that the employee does so during or after the calendar year in which she/he attained age 55

(vi) not in excess of the employee's deductible medical expenses for the year (or the amount that would be deductible if the employee itemized deductions)

(vii) made to a family member of the employee (or former family member) under a state court domestic relations order

These rules apply to all deferred compensation plans except that the exceptions described in (v), (vi), and arguably (vii) do not apply to SEPs, the requirement in (iv) that the employee have separated from service does not apply to SEPs, and distributions under Section 457(a) plans are not subject to the 10 percent penalty tax in any case.

Plan loans

Employees may generally be permitted to borrow plan assets from a defined benefit pension plan, defined contribution plan, or Section 403(b) plan without jeopardizing the plan's favorable tax treatment. (As a practical matter, loans from the latter two types of plan are much more common than loans from defined benefit pension plans.) Such loans are not permitted with respect to SEPs. In the case of a Section 457(a) plan, any loan to an employee would technically be treated as a loan from the employer and thus would not be subject to any special rules.

A loan from a defined benefit pension plan, defined contribution plan, or Section 403(b) plan is generally treated as a loan, rather than as a distribution, and thus is not subject to income taxes or penalty taxes. However, some or all of a plan loan will be treated as a distribution for such purposes if the loan violates certain requirements. Very generally, those requirements are as follows.

Limitation on amount. The sum of all loans to an employee from all plans of an employer may not exceed the lesser of

—$50,000 or

—the greater of $10,000 or 50 percent of the value of the employee's vested benefits under the plans.

In addition, very generally, the $50,000 maximum is reduced by the amount of loan principal paid by the employee during the prior 12 months.

Repayment period. In general, a plan loan must be required to be repaid within five years and must, in fact, be repaid within five years. There is an exception from this rule for loans used to acquire the employee's principal residence. There is no official guidance as to what repayment period is permissible with respect to a principal residence loan.

Quarterly payments. Plan loans must be repaid in substantially equal payments that are made at least quarterly. Of course, the loan may also be repaid or accelerated prior to the end of the stated term.

Pledges. For purposes of the requirements listed above, employees who pledge or assign any portion of their plan benefits shall be treated as having received a plan loan of the amount pledged or assigned.

Effect on the plan. Even if a loan is treated as a distribution because it does not satisfy the rules described above, it is not necessarily treated as a loan for purposes of the prohibitions on distributions described above. A loan generally will be treated as a distribution for those purposes only if it is not a bona fide loan, i.e., there was no real intent that the loan would be repaid.

Minimum distribution rules

In general, a deferred compensation plan does not qualify for favorable tax treatment unless the plan requires that employees begin receiving distributions from the plan by no later than April 1 of the year immediately following the later of the year the employee attains age 70 or the year the employee retires. The year the employee retires does not apply to a SEP. In addition, the commencement of distribution of amounts that were in a Section 403(b) plan as of December 31, 1986, may be delayed beyond the dates described above, but generally not beyond age 75.

Limits on benefits and contributions

In order to qualify for favorable tax treatment, a deferred compensation plan must limit the contributions or benefits that it provides to each employee.

The limits discussed below are in certain circumstances a function of an employee's compensation. For a discussion of an issue affecting the amount of compensation an employee is treated as receiving for these purposes, see "Effect of pretax employee contributions on benefits" below.

Defined benefit pension plans

In general, under Section 415 of the Internal Revenue Code, employees may not be entitled to an annual benefit attributable to employer contributions under a defined benefit pension plan in excess of the lesser of $102,582 (indexed) or the employees' average compensation over the three-consecutive-year period in which their compensation was the highest (indexed in years after the employees separate from service).

Both the $102,582 (indexed) figure and the average compensation limit may be reduced with respect to an employee who is (or has been) a participant in a defined contribution plan or a SEP maintained by the same employer. This reduction applies under Section 415(e) and can in certain circumstances have a very significant effect on the amount of annual benefits permitted with respect to a participant. If a participant in a defined benefit pension plan also participates in a Section 403(b) plan maintained by the same employer, rather than a defined contribution plan or SEP, the reduction under Section 415(e) only applies in limited, avoidable circumstances. Accordingly, for an employer with a defined benefit pension plan that is considering adopting a supplemental qualified plan, Section 403(b) plans have this advantage.

In circumstances in which the Section 415(e) reduction would otherwise apply to the annual benefit limit described above, an employer may choose to have the reduction apply instead to the defined contribution limit (which applies to Section 403(b) plans and SEPs, as well as to defined contribution plans) discussed below.

Employee contributions. The benefit attributable to after-tax employee contributions to a defined benefit pension plan is not subject to the limit described above. Instead, for purposes of the Section 415 limits, employee contributions to a defined benefit pension plan are generally treated as contributions to a defined contribution plan.

It appears, though it is far from clear, that the benefit attributable to pick-up contributions to a defined benefit pension plan is not subject to the limit described above and that, for purposes of the Section 415 limits, pick-up contributions are treated as employer contributions to a defined contribution plan.

Ancillary benefits. If an employee is entitled to certain types of ancillary benefits, such as payments after death other than as a life annuity to the spouse, the ancillary benefits must be converted into a life annuity of equivalent value (for testing purposes only), added to the employee's regular benefit, and the total then tested against the limit described above.

Early or late retirement. If an employee's benefits under the plan begin before age 62, the $102,582

(indexed) figure must be actuarially reduced with respect to that employee to reflect the fact that benefits are commencing before age 62. However, if the benefit begins at or after age 55, the actuarial reduction shall not reduce $102,582 (indexed) to an amount lower than $75,000 (not indexed). If the benefit begins before age 55, the limit is the greater of (1) the actuarial equivalent of a $102,582 (indexed) benefit commencing at age 62 or (2) the actuarial equivalent of a $75,000 benefit commencing at age 55.

If an employee's benefit begins after age 65, the $102,582 (indexed) figure is actuarially increased to reflect the commencement of benefits after age 65.

Benefit of $10,000 permitted. A special rule allows a defined benefit pension plan to provide an annual benefit of $10,000 or less to an employee, even if that benefit would otherwise exceed the limit described above. This special rule only applies, however, if the employee has never been covered under a defined contribution plan or SEP, or in certain circumstances a Section 403(b) plan, maintained by the same employer.

Adjustment of limit based on years of service or participation. The $102,582 (indexed) limit is reduced proportionately for an employee who has less than ten years of participation in the plan (or under a plan amendment). For example, if an employee has only been a participant for two years, her/his benefit could not exceed 20 percent of $102,582 (indexed) or $20,516 (indexed).

The average compensation limit and the special $10,000 amount are reduced in a similar fashion but based on years of service with the employer rather than years of participation in the plan.

Collective bargaining exemption. There is a narrow exemption from the average compensation limit for collectively bargained plans that meet a series of requirements, including, for example, (1) employees must be eligible to participate in the plan after not more than 60 days of service; (2) employees are 100 percent vested in their benefits after no more than four years of service, and (3) an employee's benefits are not determined by reference to the employee's compensation. Even if a plan meets the requirements, the exemption generally applies only to employees whose compensation is less than the average compensation of employees covered under the plan.

Plan aggregation and disaggregation. For purposes of the limit described above, all defined benefit pension plans maintained at any time by an employer are treated as a single plan, i.e., are "aggregated." Thus, if the benefits earned by an employee under two plans maintained by the same employer exceed the applicable limit in total, the limit is considered exceeded.

In addition, for purposes of the limit described above, related employers are treated as a single employer. (There is little guidance with respect to the circumstances in which public employers are considered to be related.)

If a single plan is maintained by two or more unrelated employers, the benefit earned under the plan by an NEA member is, for purposes of applying the limit described above, generally divided into separate benefits based on the benefits earned from each employer.

Special election. Congress has provided a special election to state and local government employers. If an employer makes this election, the limit described above is deemed satisfied with respect to an employee of such employer if the employee's benefit under the employer's plan does not exceed the amount that would be payable under the plan without regard to any plan amendments adopted after October 14, 1987. However, this favorable treatment only applies to employees who first became participants in the plan before January 1, 1990.

There is a significant condition attached to this election. If an employer makes this election, employees ineligible for the favorable treatment generally become subject to the version of the limit that applies to taxable employers. Under that version, the $102,582 (indexed) figure is actuarially reduced (or increased) if benefits begin before (or after) an employee's Social Security retirement age (which is between 65 and 67, depending on the employee's current age). In addition, the $75,000 rule described above does not apply. In comparison with the rules described above, this version of the dollar limit is much lower for employees who retire early and begin receiving their benefit.

The election must be made by the end of the first plan year beginning after 1989.

Defined contribution plans

In general, under Section 415 of the Internal Revenue Code, the sum of the employer and employee contributions made on behalf of an employee to defined contribution plans in a year may not exceed the lesser of $30,000 (indexed on a delayed basis) or 25 percent of the employee's compensation. For this purpose, any amount that is forfeited by one employee in a defined contribution plan and is allocated to a second employee is treated as a contribution on behalf of the second employee.

"Rollover contributions" and "transfers," both of which are discussed below, are not treated as contributions for purposes of the limit described above.

As in the case of defined benefit pension plans, all defined contribution plans maintained by an employer are treated as a single defined contribution plan for purposes of the applicable limit. The rules with respect to related employers and with respect to a defined benefit pension plan maintained by two or more unrelated employers also apply to defined contribution plans.

Section 403(b) plans

Contributions made on behalf of an employee to a Section 403(b) plan are generally subject to two limits. First, such contributions are subject to the limit applicable to defined contribution plans under Section 415. However, unless an employee makes one of the elections referred to below, Section 403(b) plans are not aggregated with defined contribution plans for purposes of this limit.

Second, employer contributions and pretax employee contributions on behalf of an employee in a year may not exceed the "exclusion allowance" established under Section 403(b) itself. The exclusion allowance is generally the excess of (1) 20 percent of the employee's taxable compensation for the year, multiplied by her/his years of service with the employer, over (2) the total of the nontaxable employer contributions and pretax employee contributions made by or with respect to the same employer to Section 403(b) plans, defined benefit pension plans, defined contribution plans, Section 457(a) plans, or certain 457(f) plans on behalf of the employee for all prior years.

There are special rules that under certain circumstances provide more liberal limits than those described above. Each employee may elect which, if any, of the special rules to use.

SEPs

For purposes of the Section 415 limits described above, a SEP is treated as a defined contribution plan. In addition, under Section 402(h) of the Internal Revenue Code, contributions to a SEP on behalf of an employee may not exceed the lesser of 15 percent of the employee's taxable compensation or $30,000 (indexed on a delayed basis) reduced by a certain amount in the case of SEPs that provide larger contributions for "highly compensated employees" than for "nonhighly compensated employees" (as a percentage of compensation). See "Nondiscrimination Rules" below for a definition of "highly compensated employee."

Section 457 plans

In general, under Section 457 itself, the limit on the amount that may be deferred on behalf of an employee in a year under a Section 457(a) plan is the lesser of $7,500 or one-third of the employee's taxable compensation. There is also a special rule that provides a higher limit (up to $15,000) during an employee's last three years before normal retirement age. In addition, the $7,500 limit (or higher limit) is, in effect, reduced by (1) amounts deferred under other Section 457(a) plans on behalf of the same employee; (2) amounts contributed on behalf of the employee under a Section 403(b) plan; and (3) pretax employee contributions made on behalf of the employee under a 401(k) plan.

Special limit on elective pretax employee contributions

Elective pretax employee contributions are subject to the general limits described above and, in addition, they are subject to a special separate limit under Section 402(g) of the Internal Revenue Code. Generally, under this special limit, an employee may not make more than $7,979 (indexed) of elective pretax employee contributions during a calendar year to all deferred compensation plans (other than Section 457(a) plans). However, with respect to elective pretax employee contributions to Section 403(b) plans, the limit is the higher of $7,979 (indexed) or $9,500 (not indexed). Accordingly, in a few years, when the $7,979 is indexed to exceed $9,500, there will be no special Section 403(b) limit.

For employees who have at least 15 years of service, the limit on elective pretax employee contributions to Section 403(b) plans is raised pursuant to a formula, with a maximum increase of $3,000.

Pick-up contributions are not subject to this special limit.

Penalty tax on excess distributions and excess accumulations

There is a 15 percent penalty tax that applies, in addition to the generally applicable income tax, to individuals who receive "excess distributions." For this purpose, *very generally*, individuals have excess distribution if in a calendar year they receive from all deferred compensation plans (other than Section

457(a) plans) and IRAs taxable distributions in excess of $128,228 (indexed) or $150,000 (not indexed). In addition, a comparable 15 percent tax applies to individuals who die with very large accumulations of assets in deferred compensation plans (other than Section 457(a) plans) and IRAs.

Special tax treatment of distributions

Distributions rolled over to another plan or IRA[6]

Defined benefit pension plans. If an employee receiving a distribution from a defined benefit pension plan "rolls over" (i.e., contributes) the distribution to another defined benefit pension plan, a defined contribution plan, or an IRA, the amount rolled over is not taxable at that time to the employee. There are, however, certain restrictions on rollovers.

First, only three types of distributions may be rolled over. The first is a "lump-sum distribution." A lump-sum distribution is generally a single distribution of all amounts that an employee is entitled to under the plan (and under certain other plans maintained by the employer). In addition, to be a lump-sum distribution a distribution must be made (1) on account of the employee's death, (2) after the employee attains age 59, or (3) on account of the employee's separation from service.

The second type of distribution eligible for rollover treatment is a distribution on account of the termination of the plan.

The third type of eligible distribution is a partial distribution. A partial distribution is generally a distribution of at least half of the amount that an employee is entitled to under the plan. In addition, a partial distribution must not be one of a series of periodic distributions from the plan. Finally, a partial distribution must be made (1) on account of the employee's death, (2) on account of the employee's separation from service, or (3) after the employee has become disabled.

Although a distribution must meet one of the three requirements described above in order to be eligible for rollover treatment, these requirements do not apply to the amount rolled over. In other words, an employee may roll over all or only a portion of a qualifying distribution.

There are other restrictions on rollovers. Rollovers must be made within 60 days of the distribution. In addition, rollovers must consist only of amounts that would otherwise be taxable to the employee; accordingly, a distribution of after-tax employee contributions may not be rolled over. Also, distributions required under the minimum distribution rules may not be rolled over.

Special restrictions apply to rollovers of partial distributions. First, the rollover may only be made to an IRA. Second, if an employee rolls over a partial distribution, the employee will be ineligible for the special tax treatment applicable to lump-sum distributions described below with respect to the plan (and certain other plans maintained by the employer).

Defined contribution plans. Same as defined benefit pension plans described above.

Section 403(b) plans. The same rules applicable to defined benefit pension plans apply to Section 403(b) plans with the following modifications. First, rollovers from Section 403(b) plans may only be made to other Section 403(b) plans or to IRAs. Second, a distribution from a Section 403(b) plan may not qualify for rollover treatment on the basis that it is made on account of the termination of the plan.

SEPs. SEPs are generally subject to the same rollover rules applicable to IRAs, which in turn are generally the same as those applicable to defined benefit pension plans with the following modifications. First, distributions from IRAs generally may only be rolled over to IRAs. Second, any SEP distribution is eligible for rollover treatment. Third, only one IRA distribution may be rolled over during a 12-month period though this limitation does not apply to direct transfers between IRAs.

Section 457 plans. Distributions from Section 457(a) plans may not be rolled over to any other type of plan. However, amounts to which an employee is entitled may be transferred directly from one Section 457(a) plan to another Section 457(a) plan.

Distributions of after-tax contributions

As discussed above, in general, a distribution from a deferred compensation plan is taxable to the recipient except to the extent that the distribution is considered to be a return of the employee's after-tax contributions. Thus, in the case of plans that permit after-tax employee contributions, it is necessary to determine the amount of a distribution that is considered to consist of after-tax employee distributions.

Prior to the Tax Reform Act of 1986, the law

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[6] For a discussion of another means of moving assets from one deferred compensation plan to another without taxation, see "Asset Portability" below.

permitted, under certain circumstances, the first distributions from a deferred compensation plan to be considered to be after-tax employee contributions. Thus, employees could generally receive on a nontaxable basis all of their after-tax employee contributions prior to receiving any taxable amounts. (One of the rules that permitted such tax treatment was often referred to as the "3-year basis recovery rule.") However, the Tax Reform Act of 1986 generally provided that each distribution will be treated as consisting partially of a nontaxable return of after-tax employee contributions and partially of taxable amounts. (There are "grandfather" rules preserving the old system for certain distributions.) Very generally, the proportions of nontaxable and taxable amounts will be based on the total amount of each to which the employee is entitled under the plan.

Special tax rates applicable to lump-sum distributions

In general, a lump-sum distribution from a defined benefit pension plan or defined contribution plan is eligible for taxation at lower rates if no part of the distribution is rolled over. In order to qualify for this treatment, the lump-sum distribution must meet the following requirements. First, the distribution generally must be received after the employee has attained age 59. Second, the employee generally may not have used the special lower tax rates with respect to any prior lump-sum distribution. Third, the employee must have been a participant in the distributing plan for at least five years prior to the year of distribution.

In general, the special lower tax rates are achieved through a rule called "5-year averaging."

This is one of the areas where the treatment of money purchase pension plans differs from that of profit-sharing plans. In general, in determining whether a distribution constitutes a lump-sum distribution for purposes of the special tax rates, a money purchase pension plan is aggregated with a defined benefit pension plan. Accordingly, if an employee is entitled to benefits under both a money purchase pension plan and a defined benefit pension plan and such employee receives a total distribution from the former but not from the latter, the distribution does not constitute a lump-sum distribution (because it was not a total distribution from the combined plans). If, however, in this example, the former plan were a profit-sharing plan rather than a money purchase pension plan, the distribution described in the previous sentence would constitute a lump-sum distribution.

The special lower tax rates do not apply to Section 403(b) plans, SEPs, or Section 457(a) plans.

Nondiscrimination rules

Nondiscrimination rules generally require that deferred compensation plans (other than Section 457(a) plans) not favor an employer's highly compensated employees over the employer's nonhighly compensated employees. See Sections 401(a)(4), 401(k), 401(m), 403(b)(12), 410(b), and 410(c) of the Internal Revenue Code. Another aspect of the nondiscrimination rules, which is contained in Section 401(a)(26) of the Internal Revenue Code, generally requires that all such plans cover at least the lesser of 50 employees or 40 percent of the employer's employees. (Although this aspect of the rules does not apply to SEPs; typically more restrictive rules apply to SEPs under Section 408(k) of the Internal Revenue Code.)

The IRS has, with certain exceptions, suspended the application of all nondiscrimination rules to public plans until 1993. The exceptions are SEPs, Section 403(b) plans with respect to the availability of elective pretax employee contributions, and 401(k) plans with respect to the availability and amount of pretax employee contributions. In addition, there are arguments, albeit weak ones, that (1) Section 403(b) plans are subject to a nondiscrimination rule applicable to the availability and amount of contributions other than elective pretax employee contributions and (2) defined contribution plans and certain defined benefit pension plans are subject to a nondiscrimination rule applicable to after-tax employee contributions and employer matching contributions. (It may well be that the three clear exceptions, as well as the possible exceptions described in the prior sentence, were inadvertent on the part of the IRS.)

During the period prior to 1993, the IRS may well establish special rules for public plans that take into account their unique circumstances. When the nondiscrimination rules do become applicable to public plans, it is also possible that they will not apply to public plans that are maintained pursuant to a collective bargaining agreement ratified prior to the date that the IRS establishes such special rules. It is also possible that the period during which the nondiscrimination rules do not apply to public plans will be extended beyond 1992.

Even if the nondiscrimination rules were to be made applicable without any additional special rules for public plans, the nondiscrimination rules generally

would not have much effect on NEA members for the reasons set forth below.

First, if NEA members are covered by their own plan and none of those members is a highly compensated employee, then with certain limited exceptions, the plan automatically satisfies the nondiscrimination rules. Those exceptions are generally SEPs and the part of a Section 403(b) plan that accepts elective pretax employee contributions.

In this regard, the following provides a *very general* summary of the definition of a highly compensated employee *as it will apply to most public educational institutions*.[7] A highly compensated employee includes any employee who in the preceding year received compensation in excess of $50,000 (indexed) or was an officer of the employer and received compensation in excess of $45,000 (indexed).[8] An employee is also highly compensated if she/he meets one of these requirements in the current year and is in the top 100 employees of the employer by compensation. Finally, if, in a year, no employee of the employer meets one of the above requirements, the highest paid employee is considered highly compensated.

The second reason that the nondiscrimination rules generally would not have much effect on NEA members is that there are certain very favorable rules for plans maintained pursuant to a collective bargaining agreement. In general, based on proposed new IRS regulations, there is a strong argument that if a plan for NEA members benefits at least the lesser of 50 employees or 40 percent of the NEA members covered by the collective bargaining agreement, the plan automatically satisfies the nondiscrimination rules. The most significant exceptions to this general rule are SEPs, Section 401(k) plans with respect to the availability and amount of pretax employee contributions, and the part of a Section 403(b) plan that accepts elective pretax employee contributions. In addition, this general rule does not apply to the extent that employees of the plan or of NEA itself are covered under the plan.

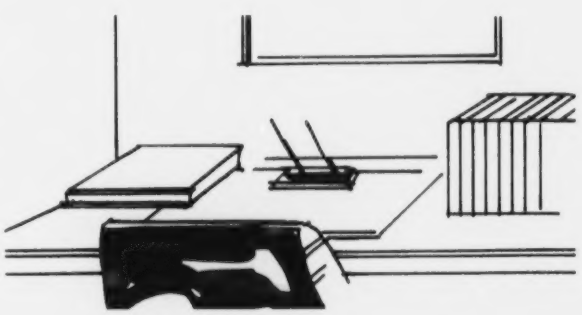
In summary, the potential nondiscrimination problems for NEA members are generally limited to SEPs and elective pretax employee contributions to Section 403(b) plans. With respect to those types of plans, the nondiscrimination rules are generally satisfied if all employees are treated in the same manner under the plan.

With respect to other types of plans, eligibility requirements (such as age, service, or job classification requirements) for participation in a plan for NEA members may generally be determined without regard to the nondiscrimination rules. The same is also true of the eligibility requirements for specific levels of benefits under the plan.

Vesting

Defined benefit pension plans and defined contribution plans

The vesting rules applicable to defined benefit pension plans and defined contribution plans maintained by private employers do not apply to such plans as maintained by state or local governments. There are, however, certain vesting rules that do apply to public plans. First, if a plan is terminated or there has been a complete discontinuance of contributions under the plan, employees' benefits under the plan must be 100 percent vested to the extent there are sufficient assets in the plan. For purposes of this rule, a "termination" includes both a partial termination and a complete termination of a plan. A partial termination may occur, for example, when a substantial group of employees who were covered by the plan are excluded by reason of a plan amendment or by reason of being discharged by the employer. A partial termination may also occur if the plan's benefits are reduced or the plan's requirements for eligibility or vesting are made more stringent.



[7] Rules relating to employees who receive compensation in excess of $75,000 (indexed) or who are in the top 20 percent of the employer's employees by compensation are not described because they rarely have a practical effect on public employers. A rule relating to employees who own more than 5 percent of the employer is also omitted.

[8] Technically, the definition of "highly compensated employee" described in the text and in this footnote, which is contained in Section 414(q) of the Internal Revenue Code, does not apply for purposes of nondiscrimination tests applicable to defined benefit pension plans and defined contribution plans. The determination of highly compensated employees for purposes of that test is based on all the facts and circumstances. However, it may well be reasonable to use the more precise Section 414(q) definition under the facts and circumstances.

Under a second vesting rule, the application of the plan's vesting schedule must not result in discrimination in favor of higher paid employees. Such discrimination may occur, for example, if the rate of turnover among lower paid employees is significantly higher than the rate of turnover among higher paid employees. If an employer adopts a rapid vesting schedule,[9] however, the employer generally avoids the risk of such a finding of discrimination (unless the employer engages in abusive practices such as firing employees immediately before they become vested).

It appears, though not clearly, that the application of this vesting nondiscrimination rule to public plans is suspended until 1993 under the generally applicable suspension of nondiscrimination rules described above.

It also appears, though not clearly, that a plan maintained by a state or local government must provide that an employee's benefit will be 100 percent vested when the employee (1) attains the plan's normal retirement age and (2) satisfies other requirements applicable under the plan such as with respect to service for the employer or employment with a subsequent employer. In the case of a profit-sharing plan, the requirement described in (1) does not apply.

If employees do not become 100 percent vested in their benefit and thus forfeit the unvested portion, the forfeited amount generally must be treated, in effect, as an employer contribution to the plan, thus decreasing the amount the employer actually has to contribute. In the case of a defined contribution plan, however, an employee's forfeiture may alternatively be used to increase the benefits of other employees.

Section 403(b) plans

Although Section 403(b) plans are typically 100 percent vested at all times, they are not required to be. Section 403(b) plans appear to be subject only to the vesting nondiscrimination rule (which, as noted, may not apply until 1993).

SEPs

Contributions to SEPs must be 100 percent vested at all times.

Section 457(a) plans

There are no vesting rules applicable to Section 457(a) plans.

Portability

In general, the concept of portability relates to employees' ability to preserve their deferred compensation benefits when they move to a new employer. Discussion of this concept is divided below into two general topics: asset portability and service portability.

Asset portability

The term "asset portability" is used in this report to refer to an employee's ability to move retirement benefits from a former employer's plan to a new employer's plan or to an IRA.

There are two ways to move retirement benefits from one plan to another plan or to an IRA. One way is by a rollover. The rollover rules are described under "Special Tax Treatment" above. It should be noted, however, that a rollover to a plan (as opposed to an IRA) is only possible if the recipient plan accepts rollovers (which not all plans do).

The second way of moving retirement benefits is by a direct transfer from one plan to another plan or IRA. Transfers are permitted from defined contribution plans to other defined contribution plans or to defined benefit pension plans. Transfers from defined benefit plans to other defined benefit plans or to defined contribution plans are permitted, but, at least in certain cases, only on the condition that the transferor plan has been terminated, thus triggering 100 percent vesting. Transfers between Section 403(b) plans are permitted, as are transfers between Section 457(a) plans. Finally, SEPs are comprised of IRAs and transfers between IRAs are permitted.[10]

The transfers described above generally may consist of all or a portion of an employee's benefits under the transferor plan. However, in certain cases restrictions on the employee's benefits that apply under the transferor plan (such as withdrawal restrictions)

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[9] The following is an example of such a rapid schedule:

Completed years of employment	Vested percentage
4	40%
5	45%
6	50%
7	60%
8	70%
9	80%
10	90%
11 or more	100%

[10] The transfers described above are the most common. Under certain circumstances, transfers not described above may also be permitted.

must apply to the transferred benefits in the transferee plan. In addition, a transfer is only possible if it is permitted by both the transferor and transferee plan.

Service portability

The concept of service portability is generally relevant only to defined benefit pension plans. An employee's benefits under a defined benefit pension plan are generally based on the employee's number of years of service and compensation history with the employer. However, an employer's defined benefit pension plan is generally not prohibited from giving one or more employees credit for years of service for and/or compensation from another employer or class of employers (e.g., all other public educational organizations in the same state or, less typically, all such organizations in any state). Such credit removes a significant impediment to changing jobs and thus may be a desirable item to bargain for in the context of a defined benefit pension plan. (If, however, an employer provides such credit to an employee under its defined benefit pension plan, the employer may also wish to include a provision in the plan under which the employee's benefits are reduced by the benefits earned by the employee from the employer with respect to which credit is being given.)

Although as noted there is no flat prohibition against such credit, the amount of credit a particular employee may receive may be limited. As noted above, the $102,582 (indexed) limit generally is phased in over ten years of participation in the *current employer's* defined benefit pension plan; thus, an employee with one year of participation in such plan is limited to *$10,258* (indexed), regardless of years of participation in another employer's plan. As also noted above, the average compensation limit is subject to a similar phase-in except that it is based on years of *service* with the current employer. Moreover, the average compensation limit is based on compensation from the current employer, without regard to compensation from another employer.

The limit problems described in the prior paragraph do not apply if the employers are related and thus are treated as a single employer for the purposes of the limit.

ERISA

Deferred compensation plans maintained by state and local governments are exempt from the non-tax rules of the Employee Retirement Income Security Act of 1974 (ERISA). Thus, such plans are exempt from the federal fiduciary rules that govern matters such as how trust assets are invested. Of course, any fiduciary standards under state law would apply.

In addition, the Internal Revenue Code requires, as a condition of the favorable tax treatment described above, that (1) defined benefit pension plans and defined contribution plans be maintained for the "exclusive benefit" of the employer's employees (and their beneficiaries) and (2) transactions between the employer and such plans be fair to the plan. These rules would be violated if, for example, the trust assets are used not for the benefit of the employees but rather for the employer's own purposes. Thus, the investment of trust assets, as well as other aspects of plan operation, are subject to tax rules protecting the interests of the employees.

Due to their exemption from ERISA, governmental defined benefit pension plans are not insured by the Pension Benefit Guaranty Corporation (PBGC) and, accordingly, need not pay premiums to the PBGC.

Miscellaneous

Availability of an advance determination from the IRS regarding the tax treatment of a deferred compensation plan

The IRS has established a special procedure that employers can use to apply for an IRS determination that a defined benefit pension plan or defined contribution plan satisfies the requirements under the Internal Revenue Code for favorable tax treatment, i.e., a determination that the plan is qualified. Technically, a determination letter does not ensure that the IRS will not later claim that the plan is retroactively disqualified. However, generally, the IRS will only do so if (1) there has been a change in the law or in the relevant facts, (2) the employer did not disclose all the relevant facts in its application, or (3) the plan was not operated in accordance with the law and the documents submitted by the employer.

The special procedure referred to above does not apply to Section 403(b) plans, SEPs, or Section 457(a) plans. However, employers may generally obtain a similar letter from the IRS with respect to these plans by submitting an application for a "private letter ruling."

Neither determination letters nor private letter rulings are required in order for a plan to be entitled to favorable tax treatment. However, the great majority of private sector employers apply for such a letter or ruling in order to decrease the chances that the IRS

will subsequently assert that the plan did not meet the applicable requirements under the Internal Revenue Code for favorable tax treatment. It is less common for governmental employers to seek a letter or ruling.

Entitlement to excess assets in defined benefit pension plans

A trust maintained in connection with a defined benefit pension plan may have assets in excess of the amount necessary to pay out all benefits to which employees are entitled. (This is generally not true of the other types of deferred compensation plans because in those plans all contributions and income generated by the contributions are generally allocated to the accounts of the employees.) *An employer may include a clause in a plan entitling the employer to receive the excess assets as a "reversion" if the plan is terminated at a time when there are excess assets.* (The employer could simultaneously start a new plan that is identical to the terminated plan except that the excess assets have been withdrawn.) However, employees may bargain for a plan provision entitling them to part or all of the excess assets.

Although a 15 percent tax generally applies to reversions, it is generally not applicable in the case of a state or local government.

Actuarial assumptions

Generally, an employee's benefit under a defined benefit pension plan is stated in terms of an amount, determined under the plan's formula, payable in a certain annuity form. However, as discussed above, the employee may receive the benefit in a different form, possibly in the form of a lump sum. This requires the plan to establish the value of the employee's benefit in the basic form and to determine the amount that must be paid in the different form so that the employee receives an equivalent value. This "equivalent value determination" is based on certain actuarial assumptions, such as interest rates. These assumptions, which generally must be specified in a defined benefit pension plan, can have a very significant effect on whether the amount paid in the different form actually has an equivalent value.

Effect of pretax employee contributions on nonelective contributions or benefits

Most nonelective contributions or benefits provided by an employer are based on an employee's compensation. It is important to consider the effect of pretax employee contributions on the definition of compensation that is used for this purpose. For example, an elective contribution by an employee under a Section 457(a) plan might result in a smaller amount of compensation taken into account under an employer's defined benefit pension plan, with the result that the employee's benefit under the defined benefit pension plan is smaller.

Employees may be able to negotiate for a definition of compensation that takes into account pretax employee contributions (unless the definition is fixed by state statute, for example). However, for purposes of the limits on contributions or benefits discussed above, compensation does not include pretax employee contributions, nor does it include any employer contributions (such as Section 414(h) pick-up contributions). Thus, even if the employees successfully negotiate a favorable definition of compensation under a plan, the favorable definition will not apply for purposes of the limits described above.

Chart of basic differences among plans

The following chart provides a very general summary of the basic elements of the five types of deferred compensation plans. The information provided in the chart is subject to numerous exceptions that have been discussed above; accordingly, the chart should not be relied upon as the only guidance on any question. Except as otherwise noted below, references to taxation are references to the income tax, as opposed to the Social Security tax.

Elements of Deferred Compensation Plans — General Summary

	Defined benefit pension plans: Section 401(a)	Defined contribution plans: Section 401(a)	Section 403(b) plans	SEPs: Section 408(k)	Section 457(a) plans
Plan pays employees retirement benefit based on formula	Yes	No	No	No	No
Plan pays each employee the contributions credited to her/his account, plus earnings on those contributions	No	Yes	Yes	Yes	Yes
Trust for plan assets	Yes	Yes	No	Yes	No
No taxation of any person until benefits are distributed	Yes	Yes	Yes	Yes	Yes
Distributions not rolled over are taxed to recipients except to extent of after-tax employee contributions	Yes	Yes	Yes	Yes	Yes
Under Section 414(h), pick-up contributions not taxed to employee	Yes	Yes	No	No	No

Elements of Deferred Compensation Plans — General Summary, continued

	Defined benefit pension plans: Section 401(a)	Defined contribution plans: Section 401(a)	Section 403(b) plans	SEPs: Section 408(k)	Section 457(a) plans
Elective pre tax employee contributions permitted	No	No	Yes	No	Yes
Elective after-tax employee contributions permitted	Yes	Yes	Yes	No	No
Social Security tax on contribution (if otherwise applicable)	No (except employee contributions and pick-up)	No (except employee contributions and pick-up)	Yes	No	Yes
Social Security tax on distribution (if otherwise applicable)	No	No	No	No	No
Distributions permitted prior to termination of employment	No	Yes	Yes	Yes	Yes
Distributions permitted prior to termination of employment or hardship	No	Yes	No	Yes	No

Elements of Deferred Compensation Plans — General Summary, continued

	Defined benefit pension plans: Section 401(a)	Defined contribution plans: Section 401(a)	Section 403(b) plans	SEPs: Section 408(k)	Section 457(a) plans
Certain non-annuity distributions before age 59½ subject to 10% penalty tax	Yes	Yes	Yes	Yes	No
Loans from plan to employee permitted, subject to limits	Yes	Yes	Yes	No	NA
Annual limit on benefits—Section 415(b)	Lesser of $102,582 (indexed) or employee's 3-year average compensation	NA	NA	NA	NA
Annual limit on contributions—Section 415(c)—except in case of Section 457(a) plan	NA	Lesser of $30,000 (delayed indexing) or 25% of employee's compensation	Same as defined contribution plans plus additional limitation may apply	Same as defined contribution plans plus additional limitation	Lesser of $7,500 or 33⅓% of employee's compensation

Elements of Deferred Compensation Plans — General Summary, continued

	Defined benefit pension plans: Section 401(a)	Defined contribution plans: Section 401(a)	Section 403(b) plans	SEPs: Section 408(k)	Section 457(a) plans
If maintained as supplement to defined benefit pension plan, overall limit on contributions and benefits applicable—Section 415(e)	NA	Yes	No	Yes	No
Limit on elective pretax employee contributions	NA	NA	Higher of $9,500 or $7,979 (indexed)	NA	Same as overall limit above
Rollover of distribution to IRA permitted without taxation	Yes	Yes	Yes	Yes	No
Special lower tax rates applicable to lump-sum distributions (5-year averaging)	Yes	Yes	No	No	No
Nondiscrimination rules applicable prior to 1993/after 1992	No/Yes	No/Yes	No/Yes	Yes/Yes	No/No

Health and Dependent Care Assistance Plans

Health Plans

Tax treatment of active and retired employees

The general rule is that health insurance coverage provided by an employer to an employee is not taxable to the employee, regardless of whether the employer buys the coverage from a third party (such as a commercial insurer or an HMO) or "self-insures" by paying employees' claims out of its own assets. In addition, the reimbursements or services that the employee receives under the coverage are also not taxable.

The nontaxability of health insurance coverage and of the corresponding reimbursements or services also applies for purposes of the Social Security tax (even if this tax generally applies to an NEA member).

The one significant exception to the general rule of nontaxability is that, under Section 105(h) of the Internal Revenue Code, if a self-insured health plan is discriminatory, "highly compensated individuals" are taxable on at least a portion of the reimbursements provided under the plan.

For purposes of this nondiscrimination rule, a highly compensated individual is generally defined as any employee who is among the top 25 percent of the employer's employees by compensation. Thus, if no NEA member is a highly compensated individual with respect to an employer, the nondiscrimination rule does not have any effect on the NEA members employed by that employer.

Even if one or more NEA members are highly compensated individuals, the nondiscrimination rule may have little or no effect. There are good arguments that health plans maintained pursuant to a collective bargaining agreement are or will be exempt from the nondiscrimination rule.

Establishment of a fund to provide health benefits

In some cases, it may be desirable for NEA bargaining representatives to bargain for health benefits to be provided through a trust to which the employer makes bargained-for contributions. This type of arrangement is most often desirable where the employer is providing health benefits to retired employees. If an employer does not make advance contributions to a trust, there is a risk that the employer will not have sufficient assets to provide retirees with the health benefits that were promised prior to the retiree's retirement.

If a trust is established, it is, of course, desirable that the trust be exempt from tax. This may be accomplished in two ways. First, the employer may establish a voluntary employees' beneficiary association (VEBA). A VEBA is generally a tax-exempt trust that provides certain benefits such as health insurance coverage to employees and/or retired employees. It may be advantageous under certain circumstances for the VEBA to cover NEA members employed by more than one employer. The advantage of such an arrange-

ment is that the cost of group health insurance generally decreases as the number of covered individuals increases. The primary difficulty in creating such an arrangement is coordinating the rights and obligations of the different employers contributing to the VEBA.

The second means of creating a tax-exempt trust to provide health benefits is through the use of a special account within a defined benefit pension plan or money purchase pension plan. This account, referred to as a Section 401(h) account, can only be used to provide health benefits to retirees (and their families). In addition, contributions to such an account are generally limited to 25 percent of the total contributions to the plan (other than contributions for past service) determined on a cumulative rather than annual basis.

Health care continuation rules (COBRA)

State and local governments are, with certain exceptions (generally, the District of Columbia and employers with less than 20 employees), subject to the health care continuation rules, which are commonly referred to as "COBRA." Under COBRA, an employee or an employee's family member who loses health coverage from the employer due to a "qualifying event" is entitled to continue to receive the coverage (COBRA coverage), at her/his own expense (plus an extra 2 percent of the premium cost), for a certain period. That period begins with the qualifying event and generally ends 36 months later.

Qualifying events include —

(a) The employee's termination of employment (other than by reason of the employee's gross misconduct) or reduction in hours of employment

(b) The employee's death

(c) The divorce or legal separation of the employee from the employee's spouse

(d) The employee becoming entitled to Medicare benefits

(e) The employee's dependent child ceasing to be a dependent child for purposes of the employer's health coverage

In the case of a qualifying event described in (a), the period of COBRA coverage is generally only 18 months, rather than 36 months. However, generally, under the Revenue Reconciliation Act of 1989, the 18-month period is extended to 29 months in the case of an individual who is determined, under title II or XVI of the Social Security Act, to have been disabled at the time of the qualifying event described in (a). There are also certain other situations in which the period of COBRA coverage varies from the 36-month/18-month rules described above.

There are also events that can cut short an individual's right to COBRA coverage prior to the maximum 36-month/18-month, etc., periods described above. The most common such events are (1) the individual receiving group health coverage from another source *if such coverage does not contain any exclusion or limitation with respect to any preexisting condition of such individual* or (2) the individual becoming entitled to Medicare benefits. (The language shown in italics was added by the Revenue Reconciliation Act of 1989.)

An employer may be obligated, under state law or a collective bargaining agreement, to pay some or all of the cost of the health coverage for an individual following a qualifying event. Generally, the period during which the employer pays for the health coverage counts toward the maximum period during which the employer must offer COBRA coverage. Thus, for example, if an employer provides two months of continued health coverage at no cost to an employee who has terminated employment, such employer is only obligated to offer COBRA coverage at the employee's expense for an additional 16 months.

Dependent Care Assistance Programs

Tax treatment in general

In general, dependent care assistance provided by an employer to an employee under a qualified program is not taxable to the employee for purposes of either the income tax or the Social Security tax. This is true regardless of whether the assistance is provided in the form of reimbursement of the employee's dependent care expenses or in the form of a dependent care facility provided by the employer.

Limitations and requirements with respect to favorable tax treatment

Definition of dependent care assistance

In order to qualify for the favorable tax treatment described above, employer-provided dependent care assistance must meet certain requirements. First, the

assistance must relate to expenses for the care of dependents of the employee who are either under age 13 or unable to take care of themselves. (The expenses may also be for ordinary household services if performed by the same person caring for the dependent.) Second, such care must enable the employees to work; i.e., but for the care that the employees obtain, they would have to give up their work to care for the dependent. Third, except with respect to dependents under age 13, the care generally must either take place in the employee's household or relate to a dependent who lives in the household. Fourth, the care may not be provided at an overnight camp.

Limit on the nontaxability of employer-provided dependent care assistance

Employer-provided dependent care assistance in excess of specified limits is taxable to the employee. The basic limit is $5,000 per year ($2,500 in the case of a married individual filing a separate return). However, if the employee or the employee's spouse earns less than $5,000 (or $2,500) during the year, the limit is reduced to the amount of earnings of the lower-earning spouse. Thus, if an employee's spouse does not work, all employer-provided dependent care assistance is taxable to the employee.

The limit applies to the amount of expenses an employee incurs during a year that are subject to reimbursement, not to the actual reimbursements.

Qualified program

As noted above, employer-provided dependent care assistance must be provided under a qualified program in order to be nontaxable. In order to be qualified, an employer's program must satisfy three nondiscrimination rules. All three of these nondiscrimination rules are based on the definition of highly compensated employee described under "Nondiscrimination Rules" above.

First, the group of employees eligible for the program must satisfy a complicated set of tests designed to ensure that enough nonhighly compensated employees are eligible. This test generally should not present a problem for programs maintained for NEA members. Second, benefits under the program must not be available on a basis that favors highly compensated employees over nonhighly compensated employees. If the program for NEA members makes benefits available on the same basis to all eligible employees, this second nondiscrimination rule is satisfied.

The third rule may present a problem for NEA members. Under the third rule, the average value of the assistance actually received by the nonhighly compensated employees must be at least 55 percent of the average value of the assistance received by the highly compensated employees. There are certain special rules that can make the test easier to satisfy, but if the test is nevertheless not satisfied, all highly compensated employees are taxable on all employer-provided dependent care assistance that they receive.

Dependent care credit

In general

For purposes of evaluating the advantages of establishing a dependent care assistance program, it is important to understand how dependent care credit works and how the credit interacts with an employer-provided program.

If individuals pay for their own dependent care (rather than have the employer pay for it), they are eligible for a tax credit. The tax credit is generally equal to 20 percent of the dependent care expenses paid by the individual for the year. In order to be eligible for this credit, the expenses themselves must satisfy the requirements described above, relating to the definition of dependent care assistance. (For example, the expenses must be incurred in order to enable the individual to work.)

In addition, the expenses eligible for the credit are subject to certain limits. The basic limits are $2,400 for an individual with one dependent being cared for and $4,800 for an individual with two or more dependents. This basic limit is reduced, in the same way described above, to the level of earnings of the lower-earning spouse (if such spouse earns less than the basic limit). So, again, if one spouse does not work, the credit is not available.

Finally, the rate of the credit is increased for taxpayers with "adjusted gross income" (AGI) of $18,000 or less. The maximum rate is 30 percent for taxpayers with AGI of $10,000 or less.

Interaction of program with credit

For every dollar of dependent care assistance provided by an employer to an employee under a qualified program, the amount of expenses eligible for the credit is reduced by a dollar (but not below zero). For example, assume that an employee with one dependent receives $3,000 of employer-provided dependent care assistance under a qualified program.

The limit on her/his expenses eligible for tax credit would be reduced from $2,400 to zero. (It is assumed that the lower-earning spouse rule has not already reduced the limit.) If, on the other hand, there are two dependents, the limit would be reduced from $4,800 to $1,800. That would mean a credit of 20 percent (or higher, depending on her/his AGI) of dependent care expenses up to $1,800 could be claimed.

Forms of dependent care assistance

Employer-provided dependent care assistance is almost always provided in one of two forms: a dependent care facility provided by the employer or a "cafeteria plan." The cafeteria plan approach, which is by far the most common, is discussed in the next section of this report, together with a discussion of how an employee should decide whether to use available employer-provided dependent care assistance or the dependent care credit.

Cafeteria Plans

Under proposed IRS regulations, employees who have the choice between cash and a health benefit are treated for tax purposes as if they had received the cash unless the choice is made under a cafeteria plan that is qualified under Section 125 of the Internal Revenue Code. Thus, unless the choice is made under a qualified cafeteria plan, these employees will be taxed on the value of the cash, even if they choose to receive the health benefit instead of the cash. The same rule applies to a choice between cash and dependent care assistance or among cash, a health benefit, and dependent care assistance.

If the choices described above are made pursuant to a qualified cafeteria plan, the employees who choose a health benefit or dependent care assistance are not treated as receiving the cash they could have chosen. Moreover, the health benefit or dependent care assistance chosen by an employee is treated as if it were provided by the employer and thus is nontaxable to the extent described above.

Examples

No cafeteria plan

Assume that an employee has a salary of $30,000. The employee's employer provides family health insurance to the employee, but only if the employee agrees to pay $1,000 of the $4,000 cost of such insurance. The health insurance does not provide coverage for dental or vision expenses, has a $250 deductible, and requires a 20 percent copayment by the employee up to a specified level.

Assume further that the employee agrees to pay the $1,000 for the health insurance. During the year, the employee incurs $500 of health expenses that are not reimbursable under the insurance policy (either because they were not covered, such as dental expenses, or because they were subject to the deductible or copayment rules). In addition, the employee pays $2,000 for dependent care expenses.

The employee in this example will receive a Form W-2 from the employer showing $30,000 as wages subject to income and Social Security tax (if applicable). The employee will be entitled to a dependent care credit equal to 20 percent (assuming her/his AGI exceeds $18,000) of $2,000, for a tax credit of $400. It is assumed that the employee's $1,500 of health expenses ($1,000 for the insurance and $500 for other expenses) do not exceed 7.5 percent of her/his AGI, so that no part of these health expenses is deductible under Section 213 of the Internal Revenue Code.

Cafeteria plan

Assume the same facts except that the employer also establishes a qualified cafeteria plan that allows an employee to choose health benefits and/or dependent care assistance in lieu of a part of salary. This enables the employee to make three elections *prior to the beginning of the plan year*. First, the employee could elect to give up $1,000 of salary in exchange for the employer using that $1,000 to pay the employee's share of the cost of the health insurance. This aspect of the cafeteria plan is often referred to as "premium conversion." Second, the employee could elect to forgo an additional $500 of salary in exchange for the employer's using that amount for reimbursement for the $500 of anticipated uninsured health expenses. This election would be made under a part of the cafeteria plan called a "health flexible spending arrangement" or "health FSA."[11] Third, under a "dependent care flexible spending arrangement" or "dependent care FSA," the employee could elect to give up another $2,000 of salary in exchange for the employer using that $2,000 for reimbursement for the anticipated $2,000 of dependent care expenses.

The employee who makes these three elections will receive a Form W-2 from the employer showing

[11] A health FSA is considered a self-insured health plan subject to the nondiscrimination rule of Section 105(h) of the Internal Revenue Code.

only $26,500 as wages subject to income tax and Social Security tax (if applicable) ($30,000 - $1,000 - $500 - $2,000 = $26,500). This reduction of wages by $3,500 from $30,000 to $26,500 will save income taxes of $3,500 × .15 = $525 if the employee is in the 15 percent income tax bracket ($980 if she/he is in the 28 percent income tax bracket). If Social Security taxes apply, the reduction will save an additional .0765 × $3,500 = $267.75. Thus, if Social Security taxes apply, the tax savings under the cafeteria plan are $525 + $267.75 = $792.75 for the 15 percent tax bracket. This $792.75 is almost double the $400 tax credit, which is the only tax savings lost by participating in the cafeteria plan. (Other disadvantages of a cafeteria plan are described below.)

Qualified cafeteria plan

In order to be qualified, a cafeteria plan must generally satisfy certain requirements. The following are the most significant of these requirements: (1)employee election rule, (2)"use-it-or-lose-it" rule, (3)"employer-risk-of-loss" rule, and (4)"no deferred compensation" rule. Although nondiscrimination rules generally must also be satisfied, plans for NEA members are generally exempt from these rules.

Employee election rules

In general, employees must make their elections under a cafeteria plan prior to the beginning of the year. Thus, as in the example described above, employees must predict the amount of uninsured health expenses that they will have during the year. If the prediction is too low (e.g., by electing $500 and actually having $750 of expenses), they have lost the opportunity to reduce their taxable salary by the excess ($250 in this example). In other words, the cafeteria plan still provides tax savings but not as much as it could have. If their predictions are too high, they are subject to the "use-it-or-lose-it" rule described below, which has a more adverse effect.

The requirement that elections must be made prior to the beginning of the year is mitigated to some extent by a rule that allows cafeteria plans to allow employees to change their elections prospectively if during the year they have a "change in family status." The following are examples of changes in family status drawn directly from the IRS regulations: the marriage or divorce of the employee, the death of the employee's spouse or a dependent, the birth or adoption of a child of the employee, the termination of employment (or commencement of employment) of the employee's spouse, the switching from part-time to full-time employment status or from full-time to part-time status by the employee or the employee's spouse, and the taking of an unpaid leave of absence by the employee or the employee's spouse. Another example is a significant change in the health coverage of the employee or spouse attributable to the spouse's employment.

As noted above, election changes permitted upon a change in family status must be prospective only. In other words, an employee may only change the amount of salary forgone after the change in family status occurs. For example, assume the same facts described above, i.e., that an employee elects to forgo $500 of salary in exchange for that amount being available for uninsured health expenses reimbursement. A portion of the $500 is to be taken out of each paycheck on a pro rata basis. After six months, the employee becomes divorced and wishes to reduce the election to zero. She/he can stop any further reduction of salary, but cannot change the election with respect to the $250 (6/12 of $500) by which her/his salary has already been reduced. With respect to the effect of this inability to change an election retroactively, see the discussion of the use-it-or-lose-it rule below.

Also, a change in election that is made following a change in family status must be consistent with the change in family status. For example, following the birth of a child, it might be consistent to increase one's election for dependent care assistance.

Finally, certain election changes are permitted if the premiums for the health insurance elected by the employee change or the coverage is significantly modified during the year. For instance, in the example described above, if the cost of the health insurance rose 10 percent, the employee's election to forgo $1,000 could be adjusted automatically to cover the extra cost. These rules only apply, however, if the employer purchases the health insurance from an independent third party such as an insurance company or an HMO.

Use-it-or-lose-it rule

Under the use-it-or-lose-it rule, if an employee elects to forgo salary in favor of a specified benefit, the forgone salary may *only* be used for that benefit. For example, assume the facts in the example above. Assume further that the employee incurs no uninsured health expenses during the year. In such a case, she/he simply loses the $500 of salary given up in exchange for the up to $500 of uninsured health expense reim-

bursement. The $500 may *not* be carried forward and be available in the next year.

Employees' losses under the use-it-or-lose-it rule are forfeited to the employer. NEA representatives should bargain to obligate the employer to return the losses to the employees. Under the cafeteria plan rules, the employer may return the employees' losses to the employees as a group on, for example, a per capita basis or based on the amount of each employee's election, but not based on the amount of each employee's loss.

Employer-risk-of-loss rule

The employer-risk-of-loss rule is a controversial, new proposed rule that only affects health FSAs. Under this rule, employees are entitled to reimbursement of the full amount of their annual election even if they have not yet forgone that amount of salary.

Assume the same facts as in the example above. After 3 months, the employee has only forgone $125 of salary (3/12 of $500) with respect to uninsured health expenses. However, if the employee were to incur a $500 uninsured health expense at that time, the employer would have to make immediate payment of the full $500.

Employers will clearly be concerned about their risk of loss under this rule; the employee in the above example might quit or change elections after receiving the $500. There are numerous ways for an employer to reduce this risk, but no way to eliminate it.

No deferred compensation rule

A qualified cafeteria plan generally may not be used to provide employees with a benefit in a later year. For example, employees may not reduce their salary in the current year in exchange for a benefit in the subsequent year. This prohibition does not, however, apply to (1) employee contributions to a defined contribution plan (or in certain cases to a defined benefit pension plan), (2) employer matching contributions to a defined contribution plan, (3) certain group-term life insurance, and (4) reasonable premium rebates or policy dividends paid within 12 months of the end of the year.

Disadvantages of a cafeteria plan

The employee election rule and the use-it-or-lose-it rule are negative aspects of a cafeteria plan from an employee's perspective. The following are additional disadvantages.

Social Security

When employees forgo salary under a cafeteria plan, they are reducing their wages for purposes of Social Security benefits (assuming Social Security applies).

Employer cost saving

Cafeteria plans can, in certain situations, be advantageous for employees. In other situations, employers can use cafeteria plans to shift more of the cost of health insurance to employees.

For example, assume that an employer provides health insurance costing $4,000 to every employee without requiring any employee to pay any part of the cost. Such an employer might modify its arrangement as follows. The employer simultaneously (1) provides all employees with a $4,000 employer "credit" that is in effect like a salary increase of $4,000, (2) requires employees who desire health insurance to pay the full cost of such insurance, and (3) establishes a cafeteria plan. Under the cafeteria plan, the employees can either take the $4,000 in cash or forgo it if they want health insurance. Thus, in the first year in which these modifications are effective, the employees have not suffered any financial detriment. The next year, however, when the cost of the health insurance rises to, for example, $4,500, the employer may decide that the amount of the credit will remain at $4,000. Employees who wish to receive health insurance must forgo an additional $500 of salary to receive the health insurance. The employer has thus shifted the burden of the increased cost of the health insurance to the employees.

Another effect of these types of elective arrangements is that they tempt lower-paid employees and healthier employees to take cash instead of health insurance.

Dependent care credit

In certain circumstances, it will be advantageous for an employee to use the dependent care tax credit rather than using the cafeteria plan to obtain dependent care assistance.

In general, the value of using the dependent care assistance is the sum of the individual's income tax bracket times the amount of dependent care expenses (up to the limit) plus, if applicable, 7.65 percent (the Social Security tax rate)[12] of these expenses. For an

[12] If only the hospital insurance tax applies, the figure is 1.45 percent, rather than 7.65 percent.

individual in the 15 percent bracket, this means the benefit is 15 percent of the expenses if Social Security does not apply or 22.65 percent if Social Security applies. The value of the credit ranges meanwhile from 20 percent to 30 percent of the expenses. Accordingly, for example, with respect to an individual in the 15 percent income tax bracket who is not subject to Social Security, use of the credit may be advantageous.

The above analysis does not take into account (1) the use-it-or-lose-it rule, (2) the loss of Social Security benefits connected with the use of the cafeteria plan, or (3) the effect of the use of the cafeteria plan on other federal tax provisions such as the earned income credit (which is affected because use of the exclusion reduces AGI and thus can increase the available earned income credit). Another relevant factor is the higher limit available with regard to dependent care assistance. For example, an employee with one dependent and $5,000 of dependent care expenses effectively has a choice between a tax credit on expenses of $2,400 or dependent care assistance of $5,000.

Effect on deferred compensation plans

The salary that an employee forgoes under a cafeteria plan may reduce her/his "compensation" for purposes of a deferred compensation plan. For example, an employee's forgoing of salary under a cafeteria plan could result in a smaller amount of compensation taken into account under the employer's defined benefit pension plan, with the result that the employee's benefit under the defined benefit pension plan is smaller.

Employees may be able to negotiate for a deferred compensation plan with a definition of compensation that takes into account the salary forgone under a cafeteria plan (unless the definition is fixed by state statute, for example). However, for purposes of the limits on contributions or benefits under a deferred compensation plan, which are discussed above, compensation does not include forgone salary. Thus, even if the employees successfully negotiate a favorable definition of compensation under a deferred compensation plan, the favorable definition will not apply for purposes of such limits.

These issues, relating to the effect of forgone salary on deferred compensation plans, are generally the same as those discussed above relating to the effect of pretax employee contributions to deferred compensation plans.

Other uses of cafeteria plans

Cafeteria plans may also be used by employees with respect to group-term life insurance (including postretirement life insurance under an exception to the no deferred compensation rule) and legal services benefits (if Congress extends the favorable tax treatment of such benefits).

Appendix

State Income Tax Treatment of Employee Benefits

I. Introduction

Except as otherwise noted below, the information provided in Sections II-V of this Appendix is based solely on the state revenue statutes and does not reflect other state statutes or administrative or judicial interpretations of the state revenue statutes.

The information with respect to each state is current as of the legislative session described in parentheses by the name of the state.

II. Eight states with no income tax relevant to employee benefits

Alaska (1989 regular session)
Florida (1st regular legislature, B session, 1989)
Nevada (June 1989)
New Hampshire (June 1989)
South Dakota (1989 session)
Texas (1st session of 71st legislature)
Washington (2d extraordinary session, 1989)
Wyoming (1989 budget session)

III. Seven states that incorporate the federal income tax system as set forth in the Internal Revenue Code of 1986 (the "Code") by reference with no relevant variations other than tax rates

California (1989 session)
Idaho[1] (1989 regular session)
Iowa (73d General Assembly, 1989 session)
Nebraska (1st session, 1989)
New Mexico (39th legislature, 1st regular session)
Rhode Island (January 1989 session)
Vermont (May 7, 1989)

IV. Twenty-nine states that incorporate the Code by reference, but with relevant variations

Arizona (39th legislature, 1st regular session)
Colorado (May 1989)
Delaware (134th General Assembly)
District of Columbia (May 10, 1989)
Georgia (1989 session)
Hawaii[2] (1989 regular session)
Illinois (February 5, 1990)
Indiana[3] (May 4, 1989)
Kansas (1989 regular session)
Kentucky[4] (1988 regular session)
Louisiana (1989 regular, 1st and 2d extraordinary session)
Maine (114th legislature, 1st regular session, 1989)
Maryland (1989 session)
Massachusetts (December 31, 1989)
Michigan (PA #30 of 1989 regular session)
Minnesota[5] (1989 regular session)
Missouri (1st extraordinary session, 1989)
Montana (51st legislature, 1989 regular and special session)
New York (212th session, 1989, through chapter 767)
North Carolina (November 1989)
North Dakota (April 20, 1989)

[1] Idaho follows the Code, as amended and in effect on January 1, 1990, but otherwise has no relevant variations.

[2] Hawaii follows the Code as amended as of December 31, 1988.

[3] Indiana follows the Code as amended as of January 1, 1989.

[4] Although the Kentucky statute, on its face, follows the Code without relevant variations, a relevant variation is provided by regulation.

[5] Minnesota follows the Code as amended as of December 31, 1988.

Ohio (118th Assembly, filed by December 31, 1989)
Oklahoma (May 26, 1989)
Oregon[6] (65th legislature, 1989 session)
South Carolina[7] (1989 session)
Utah (1990 general session)
Virginia (laws effective July 1, 1989)
West Virginia (1989 regular and 1st extraordinary session)
Wisconsin (1989 regular session)

V. Seven states with income tax systems that do not incorporate the Code by reference

Alabama (1989 regular session)
Arkansas (2d extraordinary session, 1989)
Connecticut (July 1989 veto session)
Mississippi (1st extraordinary session, 1989)
New Jersey (203d legislature, 2d regular session)
Pennsylvania (February 24, 1990)
Tennessee (1988 session)

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[6] Oregon follows the Code as amended as of December 31, 1988, including any amendments adopted by that date but effective later.

[7] South Carolina follows the Code as amended as of December 31, 1988.

VI. Constitutionality of state taxation of payments under retirement plans

In the 1989 case *Davis v. Michigan* the U.S. Supreme Court held that "the Michigan Income Tax Act violate[d] principles of intergovernmental tax immunity by favoring retired state and local officials over retired federal employees." Under this Supreme Court decision, the income tax systems of as many as 24 states may have been unconstitutional in that they taxed taxpayers receiving payments under state retirement plans more favorably than those receiving payments under federal retirement plans. Although most of the 24 states have changed their tax system in response to *Davis*, others have not as yet determined how to change their laws.

Further changes in state law may occur as the states affected by *Davis* address the issue of whether the Supreme Court decision must be applied retroactively. Although *Davis* did not address the issue of retroactivity, two more recent U.S. Supreme Court decisions did address this issue but in a manner that does not provide definitive answers. In addition, some state courts are grappling with the retroactivity issue.

In short, the tax treatment of payments under a state or local retirement plan is, at least in some cases, in a state of flux, which may continue for a significant period of time.

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